

Issue: 1005 Penalty (Reasonable Cause Issue)
Net Operating Loss (Pre 1986)
Statute of Limitations Application

This matter comes on for hearing pursuant to TAXPAYER (hereinafter referred to as "taxpayer") timely protest of the Notice of Deficiency (hereinafter "NOD") issued by the Illinois Department of Revenue (hereinafter referred to as the "Department") on October 12, 1994. At issue are the questions 1) whether the Illinois Income Tax Act (hereinafter referred to as "IITA") allows the Department to issue a Notice of Deficiency for adjustments made pursuant to a 1988 Internal Revenue Service audit, and 2) whether the Section 1005 penalty should be abated due to reasonable cause. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department on both issues.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency, showing a total liability due and owing in the amount of \$175,390.00.¹

2. The NOD is based on a limited scope audit of the federal changes affecting Illinois for the time period January 1, 1988 through November 31, 1991. Tr. p. 8.

3. In 1992, the Internal Revenue Service conducted an audit of taxpayer's 1988 through 1991 income tax returns. Taxpayer Ex. No. 1, 2. In the course of this audit, the IRS auditor disallowed deductions for forgiveness of interest and forgiveness of debt for the taxable year 1988. These adjustments increased federal taxable income for that year. Dept. Ex. No. 3. This increase in federal taxable income resulted in the Federal Net Operating Loss (hereinafter referred to as "FNOL") carryforward being absorbed and reduced to zero. As a result, FNOL carryforwards used previously to offset federal taxable income in 1989 through 1991 were unavailable. Additional tax due for 1989 through 1991 was assessed by the IRS, however, the IRS did not assess additional tax for 1988 because the federal statute of limitations had expired. Dept. Ex. No. 3; Tr. p. 10.

4. The federal change report, Form 4549-CG, reported the disallowed deductions. The total increase to income was \$2,274,804 for 1988. Dept. Ex. No. 3; Tr. p. 10.

¹. The Notice of Deficiency does not correctly reflect the statutory deficiency. All that is required is that the notice fulfill its purpose of providing formal notification that a deficiency in tax has been determined. Pietz v. Commissioner, (Dec. 31,596), 59 T.C. 207. Thus, the Department is able to amend the notice of deficiency to reflect the tax, interest and penalty of \$158,215.00 computed by the auditor in his report of July 21, 1994. This correct amount was, in fact, less than the amount due in the original notice of deficiency and is reflective of the deficiency calculated by the auditor in his workpapers.

5. The taxpayer filed a 1988 IL-1120X on May 13, 1994 as a result of the federal audit. Tr. p. 9; Dept. Ex. No. 3. The taxpayer did not report any federal changes to income or to the federal net operating loss for that year. Tr. p. 9; Dept. Ex. No.3.

6. The Income Tax Examination Changes, Form 4549-CG, contained the following language:

Consent to assessment and Collection - I do not wish to exercise my appeal rights with the Internal Revenue Service or to contest in United States Tax Court the finding in this report. Therefore, I give my consent to the immediate assessment and collection of any increase in tax and penalties, and accept any decrease in tax and penalties shown above, plus any additional interest as provided by law. I understand that this report is subject to acceptance by the District Director.

This report was signed by VP, Vice President of TAXPAYER. Dept. Ex. No. 3.

7. The Department auditor completed the second audit report to help clarify his position to the taxpayer. Tr. p. 14. This report clearly showed the increase of \$2,274,804.00 in federal taxable income on Line 1 and all the loss carryforwards absorbed by the 1988 income. Both audit reports arrived at the same base income of \$1,359,483.00. Tr. p. 14; Dept. Ex. No. 4.

8. The Department auditor also proposed a Section 1005 penalty due to the underpayment of tax. Tr. p. 15.

9. The federal change report, Income Tax Examination Changes, Form 4549-CG, stated that the tax due for 1988 was not assessable due to an expired statute. Dept. Ex. No. 3.

10. The affidavit of Donald L. Blair, examining agent for the IRS, stated that "even though taxable income of TAXPAYER for the 1988 tax year was increased as result of the audit, the IRS did not assess any additional tax against TAXPAYER for the 1988 tax year because the applicable three year statute of limitations prevented such assessment. Dept. Ex. No. 2.

Conclusions of Law:

Generally, the Department is limited to three years from the filing of the taxpayer's return to issue a Notice of Deficiency. 35 **ILCS** 5/905(a). Section 905(e) of the IITA provides an exception to the general three year limitation. Under this section the Department is able to issue a Notice of Deficiency within two years of a notice of federal change in the taxpayer's taxable income, any item of income or deduction, or the income tax liability reported in a federal income tax return. See, 35 **ILCS** 5/905(e). Such notice is required by Section 5/506 of the IITA.

35 **ILCS** 5/506(b) of the Illinois Income Tax Act provides:

Changes affecting federal income tax. In the event the taxable income, any item of income or deduction, or the income tax liability reported in a federal income tax return is altered by amendment of such return or as a result of any other recomputation or redetermination of federal taxable income or loss, and such alteration reflects a change or settlement with respect to any item or items, affecting the computation of such person's base income for any year under this Act, or in the number of personal exemptions allowable to such person under Section 151 of the Internal Revenue Code, such person shall notify the Department of such alteration. Such notification shall be in the form of an amended return or such other form as the Department may by regulations prescribe, ...

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35 **ILCS** 5/506. Notification is required under the IITA since an adjustment to the federal return may impact the taxpayer's state income tax liability.

In the present case, taxpayer did file a 1988 IL1120X as a result of the 1988 IRS examination changes. This return, however, did not report the IRS adjustments. The taxpayer failed to show the increase in federal taxable income on line 1 and the resulting effect on base income. Failure to comply with Section 506 allows the Department to assess additional tax pursuant to Section 905(e). Section 905(e) specifies that "a Notice of Deficiency can be issued at any time with two years after the date . . . notification is given." Taxpayer filed its 1988 IL1120X on May 13, 1994. The Notice of Deficiency issued on October 12, 1995 was issued within two years and thus, was timely pursuant to 905(e).

Section 905(e) limits the state's ability to assess additional tax to situations where the Illinois base income is impacted by the federal change after giving effect to the reported alteration. Taxpayer's argument that the reported alteration did not change taxable income, and therefore, had no impact on the taxpayer's base income is without merit.

The Internal Revenue Service's Income Tax Examination Change, Form 4549-CG (Dept. Ex. No. 3) was introduced into the record. Upon examination of this one can see how the Department auditor determined that two adjustments were made to taxable income. This report shows total adjustments of \$2,274,804.00. Dept. Ex. No. 3. It is not surprising that a redetermination of federal taxable income affects base income as in the case here seeing that Illinois uses federal taxable income as the starting point for the calculation of base income. The audit report accurately reflects these adjustments and determines a base income of \$1,359,483.00.

Taxpayer's brief quotes the affidavit of IRS agent Donald Blair in support of its argument. It should be noted that in this affidavit Mr. Blair also states "that even though taxable income of TAXPAYER for the 1988 tax year was increased as a result of the audit, the Internal Revenue Service did not assess any additional tax against TAXPAYER for the 1988 tax year because the applicable three year statute of limitations prevented such assessment." Dept. Ex. No. 2. Taxable income was indeed increased as the auditor indicates. Such change in taxable income occurred in spite of the fact that the federal statute of limitations prevented the IRS from assessment.

The basic rule in statutory construction is "the legislative intent must be gathered from the plain meaning of the words" where the meaning is clear, or in other words, where the statute is not ambiguous. Durr Drug Company v. U.S., 99 F.2d 737 (1938). The language of Section 506 provides that the taxpayer must notify the Department of alterations to taxable income, any item of income or deduction, or the income tax liability reported in a federal income tax return as a result of any other recomputation or redetermination of federal taxable

income or loss. See, 35 **ILCS** 5/506(b). Assessment of additional federal tax liability is not expressly required by our statute. The legislature could have easily required assessment of federal tax yet they chose not to include such language. It would be improper to require more than the statute clearly demands.

Such an interpretation of the statute is not overly broad in that the federal change exception to the statute of limitations only applies in limited circumstances. The Department must still adhere to the general three year statute of limitations in most instances. Only where the taxpayer has failed to correctly report items of income and deduction to the IRS would the statute of limitations exceptions provided for in 905(e) apply.

IITA Section 403(b) "Effect of Determination for Federal Purposes" further supports the Department's position when it states:

Adjustment. A final determination pursuant to the Internal Revenue Code adjusting any item or items of income, deduction or exclusion for any taxable year shall be correct for purposes of this Act to the extent such item or items enter into the determination of base income.

Taxpayer signed the federal change form the language of which clearly allows the immediate assessment and collection of any increase in tax and penalties. Taxpayer waived his right to appeal the findings of this report in United States Tax Court. Dept. Ex. No. 3. These final federal figures are therefore correct to the extent they enter into the determination of base income, which clearly occurred, thus placing the taxpayer under a duty to notify the Department pursuant to 506(b).

86 Ill. Admin. Code ch. I, Sec 100.9200 also does not require the IRS to assess additional tax in order for the Department to issue a notice of deficiency. Taxpayer wrongly asserts that the effect of this regulation is to bar the Department from issuing a notice of deficiency where no additional federal tax liability resulted from the IRS audit. The taxpayer points out that this regulation requires the Department to "rely and accept" the determinations

of the IRS as to the taxpayer's taxable income. Taxpayer fails to understand that the IRS did in fact redetermine their taxable income regardless of the fact that additional tax was not assessed.

It is the taxpayer's burden to notify the Department of changes to federal taxable income. The correct determination of state tax liability relies on an accurate representation of federal taxable income, thus, the legislature has allowed an extension of the statute of limitations in regards to federal changes. This exception is important because it allows the Department an opportunity to assess the additional tax which the taxpayer initially had the burden to correctly report.

The auditor also proposed a penalty under Section 1005. For periods prior to January 1, 1994¹, Section 1005 of the Illinois Income Tax Act provides in part:

If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause... .

35 **ILCS** 5/1005.

To avoid the imposition of the Section 1005 penalty under the IITA, a taxpayer must affirmatively put forth evidence which establishes that the taxpayer acted in good faith and exercised ordinary business care and prudence. See, IRC Sec. 6664(c). Ordinary business care and prudence is determined by examining all of the facts and circumstances in a particular case.

Taxpayer's failure to report the redetermination of federal taxable income and its resulting effects on base income is not conduct which satisfies the applicable standard. Taxpayer was aware of its duty to notify the Department, as evidenced by its filing a 1988 amended return. In this instance though, the

¹. As of January 1, 1994, Section 1005 penalties are provided for under the Uniform Penalty and Interest Act. See, 35 **ILCS** 735/3-1 *et seq.*

taxpayer failed to notify the Department of the alterations which is the sole purpose behind 506(b). By signing the federal change report they acknowledged that their 1988 reported federal taxable income was incorrect, and that, but for the expiration of the federal statute of limitations, their company would have been assessed additional tax in 1988. Upon reading the applicable IITA section and knowing full well the effect of these adjustments, a person exercising the required ordinary business care and prudence would have reported the federal changes to Illinois. Merely filing an amended return restating the original figures is insufficient.

The taxpayer has failed to exercise ordinary business care and prudence and thus, the Section 1005 should not be abated.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency be finalized as amended to reflect the auditor's report.

Date:

Christine Ladewig
Administrative Law Judge